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IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

R. C. OWEN COMPANY, PETITIONER,

VS

UNITED STATES OF AMERICA, DEFENDANT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

R. C. OWEN COMPANY, PETITIONER,

vs.

UNITED STATES OF AMERICA, DEFENDANT.

Petition for Writ of Certiorari to the United States Court of Claims

Petitioner prays that writ of certiorari issue to review the judgment of the United States Court of Claims entered February 3, 1960, dismissing plaintiff's petition for the recovery of income taxes for the years ending April 30, 1953, 1954 and 1955.

OPINION BELOW

The opinion of the Court of Claims (Appendix A hereto) has not yet been officially reported.

JURISDICTION

The judgment of the Court of Claims was entered on February 3, 1960. The Judgment of this Court is invoked under 28 U. S. C., Section 1255.

QUESTION PRESENTED

Whether twenty-year 3½% debentures issued by a corporation in exchange for assets may lawfully be treated as equity capital so as to disallow the interest deduction, although the debentures embody an unconditional obligation to pay fixed amounts of interest and principal at definite and normal times; both the ability and intention of the corporation to make such payment are unquestioned; and there is no finding of fact that the parties did not intend a true debtor-creditor relation.

STATUTES INVOLVED

So far as pertinent, the applicable statutes are as follows:

Internal Revenue Code of 1939, Sec. 23.

Deductions from Gross Income.

"In computing net income there shall be allowed as deductions: * * * (b) Interest. All interest paid or accrued within the taxable year on indebtedness. * *"

26 USC 1952 ed., Sec. 23.

Internal Revenue Code of 1954, Sec. 163.

Interest.

"(a) General Rule. There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

26 USC 1952 3d., Sup. II, Sec. 162.

STATEMENT

The plaintiff corporation was organized to acquire, and did acquire on December 1, 1946, the business and assets of a family partnership engaged in the manufacture and sale of tobacco products, especially twist chewing tobacco. The corporation issued to the partners 35,000 shares of common stock of the par value of one dollar per

share, and $800,000 of 3½% debentures maturing twenty years from date, and assumed the debts of the partnership. The Commissioner of Internal Revenue determined that the debentures did not constitute indebtedness in the fiscal years ending April 30, 1953, 1954 and 1955, and disallowed the interest deduction in those years. Payment was made, claims for refund filed and disallowed, and petition for recovery of the taxes filed with the Court of Claims.

That Court, based upon findings of fact[1], which are not questioned by petitioner, concluded "as a matter of law"[2] that the Commissioner of Internal Revenue was correct in his determination. The Court conceded that all payments on the debentures had been made when due and that they had a fixed interest rate and a fixed maturity date. No question was made either as to the intention or ability of the corporation to make future payments of both interest and principal when due. On the contrary, the corporation had operated profitably and had accumulated a large earned surplus. There was no finding of fact that the parties did not intend a true debtor-creditor relation. The Court nevertheless held that the debentures did not constitute indebtedness, saying that there were "numerous other characteristics more indicative of contributions to capital, i. e. capital stock."[3] The circumstances which the Court called "characteristics" were described by the Court in language which we shall now quote, adding a comment after each quotation designed to show that the circumstance is at least equally consistent with the treatment of the debentures as indebtedness:

1. "In the first place, no money was loaned to the corporation by the recipients of the debentures nor

[1] Infra, pp. 18-29.
[2] Infra, p. 29.
[3] Infra, p. 16.

did the partners pay anything to the corporation for the debentures."

But an obligation for the purchase price of property may qualify as indebtedness to the same extent as a similar obligation for money loaned. The partners did not pay money for their debentures; they paid property. It might as well have been said that they did not "pay anything" for their stock.

2. "They were issued to the partners in precisely the same proportion as their respective interests in the partnership."

This was necessary in order to qualify the transaction as a nontaxable exchange under Section 112 (b) (5), Internal Revenue Code of 1939. The stock also was issued proportionately. Prior to the taxable years in question, however, there had been a change in this proportionate ownership. R. C. Owen, Jr. and Roy Owen had become the owners of a majority of the stock, and their father, R. C. Owen, owned none, although he had owned a 72% interest in the partnership. In *John Kelley v. Commissioner*, 326 U. S. 521, there was proportional ownership in the taxable years involved; yet the debentures were held to constitute true indebtedness.

3. "No preferred stock was issued."

Many corporations do not issue preferred stock.

4. "The debentures were specifically made 'subject and secondary to any and all indebtedness incurred' by the corporation, a characteristic of common stock."

The subordination was in favor only of indebtedness "to banks or to others in the ordinary course of business," a not uncommon provision in debentures. There was such a provision in the debentures involved in *Kelley*. It was of little importance in the instant case because, as the findings of fact state, "The purchase of raw tobacco

was usually financed through banks on warehouse receipts." (Footnote 28, Findings of Fact).

5. "The holders of the debentures acquired certain voting rights not ordinarily characteristic of debentures."

The provisions referred to by the Court were (1) that the maturity date of the debentures could be accelerated, because of default, only with the concurrence or vote of the holders of 75% in principal amount; and (2) that the provisions of the debentures "in so far as they affect the holders hereof" might be changed by a 75% vote, in which event the corporation was "authorized and empowered" to issue revised debentures in exchange. But, bondholders frequently have "voting rights" of this character, which have nothing to do with management. Cf. 15 U. S. Code, Sec. 77ppp (Trust Indenture Act of 1939, Aug. 3, 1939, c. 411, 53 Stat. 1172).

6. "So it would seem that, by the terms of the debentures, R. C. Owen, as holder thereof, was excluded from control, but actually, he was very much in control; although his entire stake in the business was in the form of debenture ownership."

This statement followed the statement that R. C. Owen had completely divested himself of his holdings of stock in the corporation, but was continued as Chairman of the Board. But Mr. Owen was seventy-six years of age, and there is no suggestion in the findings of fact that the position of Chairman of the Board, in which

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[1]The Court commented (infra, p. 17) that "it might well be contended" that 75% of the debenture holders had the right to change the interest rate without the consent of the corporation. This thought originated with the Court, so that there was no opportunity for extrinsic evidence of intention. It is submitted, however, that a construction which produces so anomalous an instrument should be discarded where, as here, the language is at least equally susceptible of a different interpretation. Williston on Contracts, Revised Ed., Vol. 3, section 620.

his children kept him after they acquired stock control, was more than honorary. (See Finding 2(b) and Footnote 12).

> 7. "Without undertaking to state precisely what the debt to equity ratio was in the capitalization of the corporation, it is obvious that equity capital of $35,000.00 is entirely disproportionate in a business with a funded debt of $800,000.00 and current liabilities of $255,245.26."

Here the Court considered current liabilities as well as funded debt, but took no account of current assets; it ignored the finding of fact that the stability of the particular business "made possible the operation of the business with a relatively small amount of equity capital" (Finding 9(c)); it ignored the finding of fact that there were valuable unlisted intangible assets (consisting of brand names, which, as stated in Footnote 17, Findings of Fact, "have consistently been indispensable to the sale of the product") worth approximately $186,625 (Finding 11), so that the ratio of funded debt to equity capital was less than four to one; and it ignored the finding of fact that the capital and surplus of the corporation at April 30, 1953 had increased to $441,157.63, and at April 30, 1955 to $542,954.19, without considering the intangibles. Clearly there was no disproportion in the tax years involved, and the question would appear to be only whether the debentures constituted "indebtedness" in those particular years.[5]

> 8. "Although the company prospered during the years in question, it appears that no dividends were ever paid on the common stock, the returns to the

[5] But even if the determination is to be made as of December 1, 1946, the date of the debentures, advantage should be taken of hindsight whenever hindsight is available. *Sinclair Refining Co. v. Jenkins Petroleum Process Co.*, 289 U. S. 689. The earnings record of the corporation proved that the amount of equity capital actually provided was all that was necessary for this particular business.

owners of the business being in the form of interest on the debentures."

The implication here is that an income tax motive was involved in the issuance of debentures instead of additional stock. Doubtless there was one, although the findings of fact refer only to a different motive: "the desire of R. C. Owen (approved by his sons) to assure the continuation of family control of the business against the hazards (1) of dissolution of the partnership (under Tennessee law) upon the death of a partner, and (2) of loss of control of the business in the raising of substantial amounts of cash with which to pay inheritance taxes upon the death of R. C. Owen." (Finding 2). Had the income tax motive been predominant, it is obvious that $500,000 of debentures with a 6% interest rate would have provided a larger interest deduction than $800,000 at 3½%, and at the same time would probably have warded off the "thin corporation" accusation. In *Kelley*, the debentures called for 8% interest, *non-cumulative*.

REASONS FOR GRANTING WRIT

1. There is no statutory authority for disallowing the interest deduction because of a ratio of equity capital to indebtedness which the Commissioner of Internal Revenue considers inadequate. *John Kelley v. Commissioner* and *Talbot Mills v. Commissioner*, 326 U. S. 521, decided on the basis of the now defunct *Dobson* rule (*Dobson v. Commissioner*, 320 U. S. 489), do not support the decision. A determinative feature in the *Talbot Mills* notes, held to constitute equity capital, was the variable rate of interest, coupled with the right of the directors to defer payment of any interest at all, even when the income was sufficient. The instant decision is inconsistent with *Kelley*, where the debentures were held to constitute true indebtedness under facts less favorable to the taxpayer than here.

2. The difficulty of reconciling various court decisions applying what has come to be known as the "thin corporation" rule demonstrates the validity of a recent comment that the rule has come to be "an exercise in administrative invention and judicial legislation which has generated intolerable confusion." (Rabkin & Johnson, Federal Income, Gift and Estate Taxation, Vol. 2, p. 3551). There is no judicial authority, however, for disallowing the interest deduction where, as here, (1) the promise to pay the indebtedness is unconditional, (2) the amounts of interest and principal are definite, (3) the maturity date is definite and not unusually distant,* and (4) there is no question as to the ability or intention of the corporation to pay, and no finding of fact that the formal documents evidencing the indebtedness do not reflect the true intention of the parties.

3. The decision in the instant case is not supported by *Lee Telephone Co. v. Commissioner*, (C. A. 4, 1958) 260 F. 2d 114 (the only case cited by the Court other than *Kelley* and *Talbot Mills*) where the Court of Appeals simply held that 5% cumulative preferred stock was really preferred stock and not indebtedness, despite a sinking fund provision for retiring the stock out of earnings according to an agreed formula.

4. The decision in the instant case is contrary to *Rowan v. United States*, (C. A. 5, 1955) 219 F. 2d 51, in holding, in effect, (to use the language of the *Rowan* opinion) "that the stockholders of a corporation may not determine just how much of their funds they care to risk in the form of capital and how much, if any, they are willing to lend as a credit," and that the Commissioner is entitled "to rewrite their balance sheet for them and show to be capital what was intended to be a loan." It is also contrary to *Sun Properties, Inc. v. United States*, (C. A. 5, 1955) 220 F. 2d 171, in treating reasons for

*In this case, as in *Kelley*, the principal was due in twenty years.

scrutinizing a transaction carefully as "rational proof that it was something other than what it purported to be," (pp. 173-174) although the circumstances relied upon, including the circumstance that taxpayer may have been a "thin corporation," were equally consistent with the opposite conclusion.

5. The decision in the instant case is contrary to *Miller's Estate v. Commissioner*, (C. A. 9, 1956) 239 F. 2d 729, in failing to recognize an arrangement for preserving the continuity of a family business as a valid, personal and business reason for incorporating a partnership business and issuing a substantial amount of long term indebtedness, as well as stock, in payment for the assets.

6. The decision in the instant case is contrary to *Miller's Estate v Commissioner*, *supra*, and to *Kraft Foods Co. v. Commissioner*, (C. A. 2, 1956) 232 F. 2d 118, in failing to consider intangible assets, not reflected in book values, in determining whether the debt to equity ratio is disproportionate.

7. If the interest deduction may properly be disallowed where the ratio of debt to equity capital is considered disproportionate, there is no justification for disallowing the *entire* deduction where *some* of the indebtedness would not violate the ratio found to be reasonable. For example, in the determination of what is reasonable compensation for personal services (under Section 23(a), Internal Revenue Code of 1939, and Section 162(a), Internal Revenue Code of 1954), only the excess over what is reasonable is disallowed.

8. While much has been written on the subject of "thin corporations"[1] since *Kelley* and *Talbot Mills* were decided by this Court fourteen years ago on the basis of the *Dobson* rule, the courts are constantly called upon to

[1]Many articles on the subject are cited in a recent law journal comment entitled "The 'Thin Corporation' Problem," Volume XII, Southwestern Law Journal, p. 373 (Summer 1958).

decide cases on that subject without the benefit of more authoritative guidance.[8] The importance of the question justifies a review of the present case, in which, in spite of findings of fact which do not question either that a debtor-creditor relation was expressed in the formal documents and was genuinely intended, or that the corporation was adequately capitalized for the particular business, the Court of Claims felt that a decision for the government was required "as a matter of law."[9] The irreconcilability of the decision with that of the Court of Appeals for the Ninth Circuit in *Miller's Estate vs. Commissioner*, *supra*, where a tax court decision was reversed on quite similar facts, brings the case within Rule 19.

CONCLUSION

For the foregoing reasons this petition for writ of certiorari should be granted.

Respectfully submitted,

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[8] In the law journal comment cited in the preceding footnote the writer says: "The reasoning of the courts is very inconsistent and vague; perhaps the ultimate outcome of a 'thin corporation' decision will depend on the particular circuit in spite of the constant statement that each case depends on its own facts." (pp. 375-376). And again, in commenting on various suggestions for avoiding the problem: "Perhaps the best solutions have been either (1) to avoid the Tax Court, or (2) to be in the proper circuit." (p. 379).

[9] Infra, p. 29.

APPENDIX A

In the United States Court of Claims

No. 390–57

(Decided February 3, 1960)

R. C. OWEN COMPANY v. THE UNITED STATES OF AMERICA

Mr. William Waller for the plaintiff. *Messrs. Waller, Davis* and *Lansden* were on the brief.

Mr. Jack F. Blair with whom was *Mr. Assistant Attorney General Charles K. Rice* for the defendant. *Messrs. Abbott M. Sellers, James P. Garland* and *M. Carr Ferguson* were on the brief.

OPINION

BARKSDALE, *District Judge*, sitting by designation, delivered the opinion of the court.

This is a suit for the recovery of income taxes, in the amount of $43,680.00 claimed by R. C. Owen Company, a Tennessee corporation, to have been erroneously assessed and collected from it. The Commissioner of Internal Revenue determined that plaintiff was not entitled to deductions claimed and taken in each of three fiscal years, 1953, 1954 and 1955, as interest paid on certain of its securities called debentures, because the so-called debentures did not represent bona fide indebtedness, and the payments made thereon were not deductible as interest. The sole question involved in this case is whether or not this determination by the Commissioner was correct.

So far as pertinent, the applicable statutes are as follows:

Internal Revenue Code of 1939, Sec. 23.

Deductions from Goss Income.

"In computing net income there shall be allowed as deductions: * * * (b) *Interest.* All interest paid or accrued within the taxable year on indebtedness. * * *"

26 USC 1952 ed., Sec. 23.

Internal Revenue Code of 1954, Sec. 163.

Interest.

"(a) *General Rule.* There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

26 USC 1952 3d., Sup. II, Sec. 162.

The plaintiff corporation was organized on October 19, 1946, to acquire, and on December 1, 1946, did acquire, the family partnership of R. C. Owen, Manufacturers of Tobacco, the partners being R. C. Owen and his two sons, R. C. Owen, Jr., and Roy Owen. The interest of the father in the partnership was 72% and that of the two sons was 14% each. In return for the business and assets of the partnership, the corporation issued to the partners 35,000 shares of common stock of the par value of one dollar per share and $800,000.00 of debentures, the stock and debentures being issued to the partners in exactly the same proportion as their interests had been in the partnership. The debentures were expressly subordinated and secondary to all indebtedness incurred by the corporation, there being the recital in the debentures that:

> By the acceptance of this Debenture Bond, the holder hereof, for himself and all subsequent holders expressly agrees that this Debenture Bond shall be subject and secondary to any and all indebtedness

incurred by R. C. Owen Company, to banks or to others in the ordinary course of business. This subordination shall cease when surplus equals the amount of these Debenture Bonds.

There is also the following somewhat ambiguous provision:

> Any and all provisions and agreements of this Debenture Bond, insofar as they affect the holders hereof, may be changed, altered, or amended by a vote in writing of the holders of these Debenture Bonds holding seventy-five percent of the principal amount thereof. To accomplish this, a writing shall be executed, signed by at least seventy-five percent of the holders and filed with the Company, and thereupon, the Company is authorized and empowered to execute new Debenture Bonds in exchange for the outstanding Debenture Bonds, with the alterations or amendments as provided in said instrument.

The debentures also contained the following provision:

> In the event R. C. Owen Company fail to pay interest on this Debenture Bond when due, or commit any other event of default hereinabove set out, then and in such event, and after thirty (30) days' notice in writing to the Company, of the existence of the default, the holders of 75% in amount of Debenture Bonds then outstanding may declare the entire series of Debenture Bonds due and payable by a notice in writing to the Company, and such declaration shall mature all outstanding Debenture Bonds, with the same effect as if they had matured by lapse of time.

There has been no default, as all payments on the debentures have been made when due. However, no dividends were ever paid on the common stock.

In November 1947, after the corporation had been functioning for a year, R. C. Owen, Chairman of the

Board of Directors, made an exchange with the two sons, giving 4,000 shares of the one dollar par value common stock to each in return for $4,000.00 of debentures from each son. On December 1, 1947, R. C. Owen transferred his remaining 17,200 shares of stock to trustees for the benefit of his six children, filing a gift tax return representing that the shares of stock were valued at one dollar per share, their par value. The trust deed was irrevocable and by it R. C. Owen completely divested himself of voting rights and all other control of this stock. After this transaction, R. C. Owen owned $584,000.00 of the $800,000.00 of debentures, but he owned no stock whatever. Nevertheless, he continued to serve as chairman of the board of directors of the corporation.

Balance sheets of the partnership and of the corporation will appear later in our formal findings of fact, but it is noteworthy that the balance sheet of the corporation as of December 1, 1946, without including anything for good will, shows assests of $1,090,245.26, including inventories of $581,602.63 (principally raw tabocco), and fixed assets of $300,836.31, current liabilities of $255,245.26, together with funded debt (the so-called debentures here in controversy) of $800,000.00, with equity capital of only $35,000.00 consisting of the 35,000 shares of one dollar par value stock.

The Commissioner determined that the so-called debentures issued by the plaintiff corporation were not evidences of bona fide indebtedness, but were actually centributions to the corporation's capital Under all the circumstances, it is our conclusion that the Commissioner's determination was correct. The general rule was well stated in *Lee Telephone Co. v. Commissioner* (4th Cir.), 260 F. 2d 114, 115, as follows:

> In modern corporate practice, securities are frequently issued containing provisions formerly thought characteristic of other types of securities. Subordi-

nated debentures frequently have attributes of preferred stock and preferred stock issues sometimes contained provisions found typically in bonds for debentures. In such a case when the issue arises and it is necessary for the Court to determine whether particular payments are interest and deductible by the payor in computing its income taxes, or dividends, and, therefore, nondeductible by the payor, it is necessary to look at all of the terms and provisions of the particular security, the purpose for which it was issued, the surrounding circumstances and the general intention of the parties. The presence or absence of a particular provision rarely can be held controlling and conclusive, and the security and all payments thereon must be finally characterized after it has been viewed in all of the light which the scene affords.

The Supreme Court had this subject for consideration in the case of *John Kelley Company v. Commissioner*, 326 U. S. 521, with which the case of *Talbot Mills v. Commissioner* was considered and decided. The facts in the two cases were somewhat similar, but there were important differences. The court held that, under all the circumstances, the annual payments on the securities in the *Kelley* case should be considered as interest on indebtedness, and the annual payments on the securities in the *Talbot Mills* case should be considered as dividends and not interest. In both cases, the corporate taxpayers had labeled the securities in question as evidences of debt. In the *Kelley* case, the securities were called "income debenture bearer bonds", and in the *Talbot Mills* case, the securities were called "registered notes". The court said (p. 530):

The documents under consideration embody elements of obligations and elements of stock. There is no one characteristic, not even exclusion from man-

agement, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts. So-called stock certificates may be authorized by corporations which are really debts, and promises to pay may be executed which have incidents of stock.

It is true that the securities here under consideration have some of the indicia of evidences of debt. The securities are denominated as debentures, they have a fixed interest rate, and a fixed maturity date. However, they have numerous other characteristics more indicative of contributions to capital, *i.e.*, capital stock. In the first place, no money was loaned to the corporation by the recipients of the debentures nor did the partners pay anything to the corporation for the debentures. They were issued to the partners in precisely the same proportion as their respective interests in the partnership. No preferred stock was issued. The debentures were specifically made "subject and secondary to any and all indebtedness incurred" by the corporation, a characteristic of common stock. The holders of the debentures acquired certain voting rights not ordinarily characteristic of debentures. For instance, in the event of default by the corporation, only upon the vote of 75% in amount of the debentures can the debentures be declared due and payable.

Also, there is the specific provision that "all provisions and agreements" of the debentures, "insofar as they affect the holders hereof, may be changed, altered or amended by a vote in writing by the holders of these Debenture Bonds holding 75% of the principal amount thereof." There follows a provision that, following notification of a vote for a change or alteration, the "Company is authorized and empowered" to issue new debentures embodying the change. At the least, these provisions give certain important voting rights to the de-

benture holders. Although it may be that the entire provision only empowers 75% in amount of the debenture holders to make changes and alterations with the agreement of the corporation, it might well be contended that, by an affirmative vote of 75% in amount of the debenture holders, the provisions of the debentures may be changed at will, even to the extent of increasing the interest rate or accelerating the maturity. If such be the case, the holders of the debentures would have almost as much control of the corporation as common stockholders.

Exclusion from control of the affairs of the corporation is an important factor to be considered. Other than as suggested above, the debenture holders, by the terms of the debentures, are excluded from control. However, it seems most noteworthy that the father, R. C. Owen, principal owner of the business, after he had completely divested himself of his holdings of stock by the execution of the trust deed in December 1947, continued to be chairman of the board of directors, although he only owned debentures and no stock at all. So it would seem that, by the terms of the debentures, R. C. Owen, as holder thereof, was excluded from control, but actually, he was very much in control, although his entire stake in the business was in the form of debenture ownership.

Without undertaking to state precisely what the debt to equity ratio was in the capitalization of the corporation, it is obvious that equity capital of $35,000.00 is entirely disproportionate in a business with a funded debt of $800,000.00 and current liabilities of $255,245.26.

Although the company prospered during the years in question, it appears that no dividends were ever paid on the common stock, the returns to the owners of the business being in the form of interest on the debentures.

Under all the circumstances, it seems clear to us that the $800,000.00 represented by so-called debentures, in the formation of the corporation, definitely constituted

contributions to capital, or capital investments on the part of the partners, rather than indebtedness. Hence, the periodic payments to the debenture holders were not deductible as interest on indebtedness, and plaintiff's petition must be dismissed.

It is so ordered.

LARAMORE, *Judge;* MADDEN, *Judge;* WHITAKER, *Judge,* and JONES, *Chief Judge,* concur.

FINDINGS OF FACT

The court, having considered the evidence, the report of Commissioner W. Ney Evans, the briefs and arguments of counsel, and the exceptions of the defendant, makes findings of fact as follows:

1. (a)[1] By this action[1] plaintiff, a Tennessee corporation,[2] seeks recovery of income taxes[3] alleged to have been erroneously and illegally collected on deficiency assessments of $14,560 for each of the three fiscal years[4] ending April 30, 1953, 1954, and 1955.[5]

(b) On November 2, 1956, plaintiff filed timely claims for refund of the foregoing payments. This suit was filed on August 15, 1957. On August 30, 1957, the

[1] Jurisdiction is asserted under the provisions of 28 U.S.C. 1491.

[2] The principal office of the corporation is in Gallatin, Tennessee.

[3] Plaintiff also seeks recovery of interest, as paid by it and as allowed by law.

[4] For the 3 years the deficiencies totaled $43,680. Payment was made by plaintiff on October 25, 1956, in the total sum of $49,634.25, representing deficiencies of $14,560 for each of the 3 years plus interest in the amount of $2,858.35 for 1953, $1,984.75 for 1954, and $1,111.15 for 1955. Total interest: $5,954.25.

[5] Plaintiff had duly filed its corporate income tax returns on July 16, 1953, July 14, 1954, and July 13, 1955, for the fiscal years ending, respectively, April 30, 1953, 1954, and 1955. The deficiencies were asserted by the Commissioner of Internal Revenue by notices mailed to plaintiff on June 20, 1956, and were assessed on October 23, 1956.

District Director of Internal Revenue notified plaintiff by registered mail that its claims for refund were denied.

(c) The deficiencies arose out of the disallowance of deductions of sums paid as interest on certain debentures.[6]

2. (a) The plaintiff corporation was organized on October 19, 1946, to acquire, and on December 1, 1946, it did acquire the business and assets of a partnership known as R. C. Owen, Manufacturers of Tobacco. The partnership was owned: (1) by R. C. Owen, 72 percent; (2) by R. C. Owen, Jr., 14 percent; and (3) by Roy Owen, 14 percent.

(b) R. C. Owen, Jr., and Roy Owen are sons of R. C. Owen, who was 76 years old when the corporation was organized.[7]

(c) The tobacco manufacturing business of the partnership had been developed by the father and his sons. They considered it a stable, profitable business. Among the reasons for the transfer of the business from the partnership to the corporation, and for the methods used in capitalizing the corporation, was the desire of R. C. Owen (approved by his sons) to assure the continuation of family control of the business against the hazards (1) of dissolution of the partnership (under Tennessee law) upon the death of a partner and (2) of loss of control of the business in the raising of substantial amounts of cash with which to pay inheritance taxes upon the death of R. C. Owen. It was the senior Owen's belief (shared by his sons) that the debentures issued by the plaintiff corporation could be sold, if need should arise, to provide the requisite cash, thereby permitting retention of the capital.

[6] The Commissioner of Internal Revenue disallowed the deductions as not representing interest, because, in his view, the debentures did not represent indebtedness. No question was raised by the Internal Revenue Service with respect to payments made by plaintiff for years prior to the fiscal year ending April 30, 1953.

[7] The senior Owen was 87 at the time of trial.

stock by the two partner-sons and the other four children of R. C. Owen, all of whom were to share in his estate through a trust indenture subsequently executed.

3. (a) The plaintiff corporation acquired the business and assets of the partnership for 35,000 shares of common stock, par value $1 per share, and $800,000 of debentures, all issued as follows:

Individual	Stock		Debentures	
	Shares	Percent	Amount	Percent
R. C. Owen	25,200	72	$576,000	72
R. C. Owen, Jr.	4,900	14	112,000	14
Roy Owen	4,900	14	112,000	14

(b) Incorporated in this finding is Table 1, reflecting the balance sheets (i) of the partnership as of November 30, 1946, and (ii) of the corporation as of December 1, 1946, together with the net worth and net tangible assets[8] of each.

Sometime shortly after the corporation was formed the former partners paid into it cash surplus in the amount of $6,127.11.[9]

(c) In November 1947, R. C. Owen made an exchange with his sons, R. C. Owen, Jr., and Roy Owen, giving 4,000 shares of stock to each in return for $4,000 in debentures from each.[10] Thereafter, R. C. Owen, Jr., and Roy Owen each owned 8,900 shares of stock, representing a total of 17,800 shares, or 50.86 percent of the 35,000

[8] In each instance net tangible assets were determined by deducting intangible assets (good will) from net worth.

[9] The evidence does not explain the reason for this payment. The figure is nevertheless requisite to account for the book value of $841,127.11 of partnership assets (net worth) acquired by the corporation.

[10] R. C. Owen, Jr., testified that the swap was recognized as an uneven exchange, in that father and sons considered the stock to be of greater value than $1 per share. He further testified that he did not recognize his gain as income.

TABLE 1

Balance Sheets

(Partnership: Nov. 30, 1946. Corporation: Dec. 1, 1946)

Item	Partnership		Corporation	
	Item	Total	Item	Total
ASSETS				
Cash		$10,513.76		$10,513.76
Accounts Receivable		44,364.55		44,364.55
Inventories		581,602.63		581,602.63
Raw Tobacco	$427,985.29		$427,985.29	
Tobacco in Process	38,903.76		38,903.76	
Finished Products	70,949.70		70,949.70	
Revenue Stamps	13,976.22		13,976.22	
Supplies	29,787.66		29,787.66	
Fixed Assets		300,836.31		300,836.31
Land and Buildings	204,347.60		204,347.60	
Machinery-Equipment	86,517.92		86,517.92	
Other	9,970.79		9,970.79	
Other Assets (Receivables)		234,237.03		133,822.00
Prepaid Expenses		4,754.71		4,754.71
Intangibles (Good Will)		13,375.00		14,351.30
Total Assets.		1,189,683.99		1,090,245.26
LIABILITIES				
Current Liabilities		$306,555.90		$255,245.26
Payable to Banks	$224,435.29		$224,435.29	
Due to Others	77,549.65		26,239.91	
Accruals—Misc.	4,570.96		4,570.96	
Funded Debt.				800,000.00
Capital Account		874,515.54		35,000.00
Surplus		8,612.55		
Total Liabilities		1,189,683.99		1,090,245.26
NET WORTH		$883,128.11		$35,000.00
NET TANGIBLE ASSETS		$869,753.11		$20,548.70

shares issued. The placing of control of the corporation in the sons was the purpose of the exchange. R. C. Owen then owned debentures in the amount of $584,000.

representing 73 percent of the $800,000 of debentures, while his sons retained $108,000 (13.5 percent) each.

(d) On December 1, 1947, R. C. Owen placed his 17,200 shares of stock[11] in a trust for the benefit of his six children.[12] He retained the debentures, upon which he has since received the income as it became due in the amount of $20,440 per annum.

4. (a) The debentures were issued on the day of their date, December 1, 1946, to mature on December 1, 1966, bearing interest at the rate of 3½ percent per annum, payable semiannually upon surrender of attached coupons.

(b) Each debenture[13] contained the following provisions:

> * * * * * * *
>
> This Debenture Bond may be called and paid at any time up to and including December 1, 1956, at the price of 101% of principal and all accrued and unpaid interest, and thereafter at par plus accrued and unpaid interest * * *. Interest shall cease on any Debenture Bond, or that part of it called for redemption on the date fixed for redemption, * * *.
>
> All Debenture Bonds called and redeemed by the Company shall be cancelled and not reissued.
>
> Until the entire amount of Debenture Bonds of this series are paid in full, R. C. Owen Company covenants and agrees not to mortgage, pledge, or place any lien on any property of the Company to secure indebtedness, other than notes for deferred purchase price of realty or personalty secured by a

[11] The transaction was subsequently noted in a gift tax return, wherein the shares were listed at par value.

[12] Ownership of the stock passed from R. C. Owen under the trust indenture. He continued thereafter to serve the corporation as chairman of the board.

[13] There were 800 debentures, each of face value of $1,000.

lien on the property purchased or retention of title of personalty, and that it will maintain net current assets in the amount of $400,000, or fifty per cent of the outstanding Debenture Bonds, whichever amount is smaller. The placing of a lien in violation of this agreement or failure to maintain net current assets as herein provided, constitutes an event of default.

By the acceptance of this Debenture Bond, the holder hereof, for himself and all subsequent holders expressly agrees that this Debenture Bond shall be subject and secondary to any and all indebtedness incurred by R. C. Owen Company, to banks or to others in the ordinary course of business. This subordination shall cease when surplus equals the amount of these Debenture Bonds. Any and all provisions nd agreements of this Debenture Bond, insofar as they affect the holders hereof, may be changed, altered, or amended by a vote in writing of the holders of these Debenture Bonds holding seventy-five per cent of the principal amount thereof. To accomplish this, a writing shall be executed, signed by at least seventy-five per cent of said holders and filed with the Company, and thereupon, the Company is authorized and empowered to execute new Debenture Bonds in exchange for the outstanding Debenture Bonds, with the alterations or amendments as provided in said instrument.

In the event R. C. Owen Company fail to pay interest on this Debenture Bond when due, or commit any other event of default hereinabove set out, then and in such event, and after thirty (30) days' notice in writing to the Company of the existence of the default, the holders of 75% in amount of Debenture Bonds then outstanding may declare the entire series of Debenture Bonds due and payable by a notice in writing to the Company, and such decla-

ration shall mature all outstanding Debenture Bonds, with the same effect as if they had matured by lapse of time.

(c) Plaintiff has paid the interest on the debentures as and when due and there has been no default in any of the debentures' terms and conditions.

5. (a) From December 1, 1946, through April 30, 1956, plaintiff carried all net profits to earned surplus.[11] No dividends were paid on the common stock.

(b) The following tabulation reflects the results of plaintiff's operations in terms of net profits for the period from December 1, 1946, trough April 30, 1956:

Year ending Apr. 30	Profit before Federal income taxes	Federal income taxes	Net profit
1947[1]	($2,497.66)		($2,497.66)
1948	32,626.37	$7,060.69	25,565.68
1949	104,233.39	39,227.87	65,005.52
1950	160,446.64	60,351.39	100,095.25
1951	205,888.08	103,469.77	102,418.31
1952	97,460.11	44,758.55	52,701.56
1953	104,487.12	47,745.86	56,741.26
1954	119,197.38	54,683.76	64,513.62
1955	64,688.39	27,405.45	37,282.94
1956	44,270.23	11,573.58	32,696.65
Total	$930,800.05	$396,276.92	$534,523.13

[1] This period was for 5 months only, from December 1, 1946, through April 30, 1947. The loss reflected during this period ensued from the absorption by plaintiff of a loss by fire.

[11] Net profits were determined after taking into account all adjustments in Federal income taxes required by the Internal Revenue Service, excepting the assessments involved in this case of $14,560 for each of the years ended April 30, 1953, 1954, and 1955.

(c) The following tabulation reflects the total capital of plaintiff at the end of each of the fiscal years listed:[15]

Year ended Apr. 30	*Amount*
1948	$64,195.73
1949	129,201.25
1950	229,296.50
1951	331,714.81
1952	384,416.37
1953	441,157.63
1954	505,671.25
1955	542,954.19
1956	575,650.84

6. (a) The business of plaintiff's predecessor partnership was (as was and is the business of the plaintiff corporation) the manufacture and marketing of tobacco products, predominantly chewing tobacco of the variety known as twist.[16] Plaintiff produces 25 percent or more of the twist tobacco manufactured and marketed for domestic use in the United States. During 1946 sales amounted to 1,600,000 pounds.

(b) Practically all twist tobacco was and is sold under brand names[17] and within limited trade areas.[18]

(c) Plaintiff acquired from its predecessor partnership 27 brand names. Four of the brand names had been initiated and developed by the partnership, while 23 of them had been purchased by the partnership from other

[15] Included are $35,000 of capital stock and paid-in surplus of $6,127.71, as well as earned surplus.

[16] Twist tobacco differs substantially from plug tobacco and scrap tobacco.

[17] Brand names have consistently been indispensable to the sale of the product, although the formulas used varied little and sometimes not at all.

[18] The trade areas include Arkansas, Kentucky, Missouri, and Tennessee, and parts of Alabama, Georgia, Illinois, Indiana, North Carolina, Ohio, Oklahoma, Virginia, and West Virginia.

manufacturers.[19] The partnership balance sheet reflected intangible values represented by the brand names to the extent of their cost, $13,375.[20]

(d) Some cost to the business was involved in the development and maintenance of brand names.[21] Similarly, some value accrued to the business from the ownership and in the use of such brand names.[22]

7. (a) The earnings of the partnership, after partners' salaries, for the 6 years 1936–1941 totaled $577,628.33, for an average of $96,271.47.[23]

(b) The earnings of the partnership, after partners' salaries, for the 5 years 1942–1946 totaled $315,784.72, for an average of $63,156.94.[24]

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[19] Many of the purchases were made during the war years (1942-1945) from competitors who had encountered financial difficulties as the result of the price squueze attendant upon price control. In some instances the partnership bought the brand names only; in others it acquired the brand names with quantities of tobacco, for which a small premium had been paid.

[20] Plaintiff increased this figure by $976.30, to show intangible values of $14,351.30. The increase was in reality only an incident to the rounding out of figures after other and unrelated modivications had been made in partnership affairs in anticipation of the transfer of its assets to the corporation.

[21] In 1946, the cost of putting a new brand name into use would have been of the order of 65 cents per pound of annual sales, wherefore the dost of marketing 10,000 pounds under a new brand name would have been $6,500 for the brand name, exclusive of the product.

[22] Witnesses for plaintiff estimated the fair market value of brand names of twist tobacco in 1946 as being not less than 12¾ cents per pound of annual sales. As applied to the partnership sales of 1,600,000 pounds that year, this estimate would reflect a fair market value of the brand names used in the business of $200,000.

[23] By years the figures were: 1936, $103,815.10; 1937, $61,762.29 1938, $97,960.25; 1939, $115,141,33; 1940, $111,777.15; and 1941, $87,262.44.

[24] By years the figures were: 1942, $36,613.32; 1943, $71,481.46; 1944, $58,710.00; 1945, $92,206.86; and 1946, $56,773.08.

(c) The earnings of the corporation, before federal income taxes, for the 10 years 1947–1956 totaled $930,800.05, for an average of $93,080.01.[25]

(d) Following is a tabulation of the partnership's capital accounts:[26]

Year	*Amount*
1936	$155,403.17
1937	155,420.69
1938	194,611.30
1939	373,480.17
1940	455,791.89
1941	578,520.16
1941	578,520.16
1942	592,768.80
1943	755,550.27
1944	757,801.74
1945	873,656.72
1946	883,128.09

8. (a) During the war years the prices at which the products of plaintiff's predecessor could be sold were controlled by the OPA. The price of type 35 dark air-cured tobacco, used in twist, was not controlled. The prices of burley and flue-cured tobaccos were controlled. Burley and flue-cured tobaccos were used in the manufacture of cigarettes and in certain other tobacco products. Certain grades of dark air-cured tobacco could be used in lieu of burley. The relative demand for dark air-cured tobacco was thereby increased, resulting in a proportionately larger wartime demand for the raw tobacco used in the manufacture of twist than in some other types of tobacco.[27]

[25] The figures by years are set forth in finding 5 (b).

[26] The figures are for the beginning of the years 1936, 1937, and 1938, and for the end of the years thereafter.

[27] For example, dark fired tobacco, used in the manufacture of snuff, was in relatively greater supply than other types of tobacco. The war had caused the loss of part of the European export market.

(b) During the war years the price squeeze on manufacturers of twist tobacco was greater than it was on the manufacturers of cigarettes and snuff. The Owen partnership's earnings during the war years were lower, because of the price squeeze, than were the partnership earnings during a comparable period before the war or the corporation's earnings during a comparable period after the war.

9. (a) The earnings of the business during the years immediately preceding and immediately following World War II reflect its potential more accurately than do the earnings of the business during the war years.

(b) The earnings and financial statements of the partnership during the years immediately preceding the war and the earnings and financial statements of the corporation during the years immediately following the war reflect relative stability of the business over a period of years.

(c) Such stability made possible the operation of the business with a relatively small amount of equity capital.[28]

10. (a) Table 2, showing the average rates of return on net tangible assets during the war years (plus 1 year before and 1 year after the war) for the Owen partnership and 38 other tobacco companies, is incorporated in this finding.

(b) The evidence fails to establish comparability, other than in the manufacture of tobacco products, between the R. C. Owen partnership[29] and any of the groups or companies listed in the tabulation.[30]

[28] The purchase of raw tobacco was usually financed through banks on warehouse receipts.

[29] Plaintiff challenges the accuracy of defendant's figures, shown in the table, for the rates of return of the R. C. Owen partnership, because of the inclusion by defendant within the partnership's net tangible assets of substantial sums which, although carried on the books as part of the capital account, were so used as not to contribute to partnership income. Details are not in evidence to support the position of either party.

[30] No data were available from companies (other than Owen) engaged primarily in the manufacture of twist tobacco.

TABLE 2

Average rates of return on net tangible assets

Products and companies	Periods	Rates of return	
		Before taxes	After taxes
Twist	1941–1945	9.76	6.21
R. C. Owen Partnership	1942–1946	7.99	4.92
	Average	8.88	5.57
Cigarettes	1941–1945	20.44	10.54
Five Companies	1942–1946	19.59	10.15
	Average	20.02	20.35
Cigars	1941–1945	18.06	8.58
Nine Companies	1942–1946	21.47	10.49
	Average	19.77	9.54
Snuff	1941–1945	13.15	8.17
Three Companies	1942–1946	12.46	7.61
	Average	12.81	7.89
Grower-Dealer	1941–1945	14.97	8.45
Two Companies	1942–1946	17.22	9.55
	Average	16.10	9.00
Industry-General	1941–1945	17.58	9.02
Nineteen Companies	1942–1946	19.11	9.79
	Average	18.35	9.41

11. Plaintiff acquired from the partnership intangible assets unlisted by the partnership or the corporation of the value of approximately $186,625.[a]

CONCLUSION OF LAW

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes, as a matter of law, that the Commissioner of Internal Reve-

[a] The good will of the business, as a going concern, and including the brand names, had a value of approximately $200,000.

nue was correct in his determination that the alleged interest paid on the alleged debentures by the plaintiff in the sum of $14,560.00* for each of the fiscal years ending April 30, 1953, 1954 and 1955, was not deductible as interest, and that the plaintiff is not entitled to recover anything in this action, and therefore its petition is dismissed.

*The interest paid was actually $28,000 each year. The asserted tax deficiency was 52% of that amount, or $14,560.

